



# Understanding Investment Adviser Registration and Private Fund Due Diligence

Daren Domina • Heather Wyckoff • Michael Garrity  
Moderator: Derek Moitoso

Slide Handouts

**Hogan Conference Center**

College of the Holy Cross, Worcester, MA

**September 18, 2014**





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**COMMONWEALTH OF MASSACHUSETTS**

**Public Employee Retirement Administration Commission**

Five Middlesex Avenue, Suite 304 | Somerville, MA 02145

Phone: 617-666-4446 | Fax: 617-628-4002

TTY: 617-591-8917 | Web: [www.mass.gov/perac](http://www.mass.gov/perac)







## **UNDERSTANDING INVESTMENT ADVISER REGISTRATION AND PRIVATE FUND DUE DILIGENCE**

*Daren Domina • Heather Wyckoff • Michael Garrity*

**Moderator: Derek Moitoso | PERAC**



September 18, 2014



**10<sup>th</sup> ANNUAL EMERGING ISSUES FORUM**  
**Public Employee Retirement Administration Commission**

**Understanding Investment Adviser Registration  
and Private Fund Due Diligence**

**Daren R. Domina and Heather N. Wyckoff**  
**September 18, 2014**

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**I. Overview of Investment Adviser  
Registration - Introduction**

- Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (July 21, 2010)
  - Highlights
    - Effective July 21, 2011 (Most Provisions)
    - Elimination of Private/Small Adviser Exemption Under Section 203(b)(3)
    - Generally, \$100 Million Assets Under Management (AUM) Threshold
      - Regulatory Assets Under Management

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## Introduction

- Private Fund Adviser Exemption
  - Under \$150 Million AUM in Private Funds Only
- Foreign Private Adviser Exemption
- Venture Capital Fund Adviser Exemption
- Family Office Exclusion (vs. Multi-Family Office)
- Private Fund Records and Reports

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## Who Should Register

- Federally Registered Advisers
  - \$100 Million AUM threshold
- Mid-sized Advisers
  - Advisers with between \$25 and \$100 Million AUM
  - Federal vs. State Registration
  - Comparison to Private Fund Adviser Exemption
- Exempt Reporting Advisers
  - Modified Form ADV
  - Private Fund Advisers/Venture Capital Advisers
  - No Brochure
- Multi-Family Offices
- SEC No-Action Relief for Relying Advisers and General Partner/SPEs

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# SEC Registration

- SEC Registration and Requirements
  - IARD; Electronic Filing of Form ADV Part 1 and Part 2A
  - Adviser Fiduciary Duties and Regulatory Requirements
  - Designate Chief Compliance Officer
  - Implement Written Compliance Policies and Procedures
- Registration Timing
  - SEC Decision within 45 Days
- Nature of SEC Review
- Investment Adviser Public Disclosure Site
  - <http://www.adviserinfo.sec.gov>
  - <http://www.sec.gov/iard>
- Annual Update

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# Form ADV Part 2 Disclosures

- SEC Form ADV Part 2 (Adviser Brochure) Amendments
  - New Disclosure Requirements
  - New Form ADV Part 2A – Brochure
  - New Form ADV Part 2B – Brochure Supplement
- Form ADV Part 2A – Brochure
  - Adviser is a fiduciary – full and fair disclosure required
  - Disclosures in narrative “Plain English” format
  - Delivery to clients required (electronic delivery with consent)
  - Summary of material changes required with each annual update
  - Certain events require non-annual update of Brochure

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## Form ADV Part 2 Disclosures

- Substantive Brochure Topics Include:
  - Advisory Business
  - Fees and Compensation
  - Performance Fees and Side-By-Side Management
  - Types of Clients
  - Methods of Analysis, Investment Strategies and Risk of Loss
  - Disciplinary Information
  - Other Financial Industry Activities and Affiliations
  - Code of Ethics, Participation or Interest in Client Transactions and Personal Trading
  - Brokerage Practices
  - Review of Accounts
  - Client Referrals and Other Compensation
  - Custody
  - Investment Discretion
  - Financial Information

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## Adviser Compliance System

- Developing Written Policies and Procedures, including Code of Ethics
  - A **policy** states the Adviser's intention to comply with certain requirements and the level of compliance expected.
  - A **procedure** sets forth who has responsibility for implementing the policy, what actions are to be taken, what reports are generated, what records are kept, who supervises the activity and how.
- Adoption, Implementation and Monitoring
- Chief Compliance Officer Oversight

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# Monitoring of an Effective Compliance System

- Monitoring Compliance
  - Required annual review
    - Review all compliance policies and procedures
    - Test effectiveness of such policies and procedures
  - Interim periodic reviews
    - Ongoing sampling
    - Significant compliance events
    - Changes in business
    - Regulatory developments
- Creating and implementing a testing program
  - Documentation of annual review
  - Evidence of interim reviews and testing
  - Formulate action plans to correct any deficiencies

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# Key Compliance Areas

- Disclosures, including in marketing materials
- Use of Placement Agents
- Code of Ethics
  - Personal Transactions
  - Insider Trading
- “Tone at the Top”
  - Empowering a knowledgeable Chief Compliance Officer
- Soft Dollars and Expense Caps
- Custody and Safeguarding Client Assets
- Newly-registered Advisers
  - SEC Presence Exams
- Outsourcing of important functions
- Dual registrants (investment adviser/broker-dealer) and affiliated brokers
- Conflicts of Interest
- Differing strategies of investment vehicles
- Special issues for private equity and real estate funds

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## II. Private Fund/Adviser Due Diligence

- Due Diligence Goals/Purposes
  - Analyze the terms governing the investment as laid out in the fund's constituent documents and offering materials
  - Consider material attributes of investment manager
  - Raise and resolve issues and concerns
  - Reality-based verification of key facts
  - Satisfy fiduciary duties and comply with regulatory obligations when allocating assets to private funds and advisers
  - Identify side letter terms, proposed amendments to offering documents, or scenarios in which a single investor fund or managed account is preferable

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## Framework to Accomplish Due Diligence Purposes

- Identify your key investment decision-makers and develop standardized due diligence processes
- Coordinate between legal, compliance and business groups of manager to gather information
- Engage additional resources as appropriate (e.g., on-site visits, background checks, outside legal review)
- Phases of due diligence
  - Initial due diligence
    - Identifying factors for continuing due diligence
  - Continuing due diligence
  - Maintain records/memo for each investment analyzed

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## Universe of Documents to Review

- Offering document/subscription documents
- Bylaws/M&As/limited liability company agreement or limited partnership agreement
- RFPs, marketing materials, due diligence questionnaires
- Side letters/special classes
- Periodic investor reports/financial statements
- Form ADV and other regulatory/governmental filings
- Service provider agreements and other material agreements
- Written policies and procedures (Code of Ethics, Compliance Manual)

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## General Concerns

- Consistency
  - Are fund offering documents internally consistent?
  - Are they consistent with other written materials (marketing materials, other documents, regulatory filings)?
  - Are they consistent with information provided orally or observed during diligence visits?
- Disclosed/undisclosed conflicts of interest
- Hidden fees/insufficiently disclosed fees and expenses
- How is the fund valuing investments?
- Red flags (“trust your gut”)

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## General Concerns

- Are all service providers disclosed?
  - Administrator; custodian; prime broker; auditor; legal counsel
    - Nationally/internationally recognized?
  - Compare disclosure re: service providers to services being provided
    - Does the Administrator price or value assets or simply calculate the NAV?
    - Can the Custodian delegate duties to sub-custodians?
  - Any affiliated service providers?

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## Aspects of Due Diligence

- Type of Entity and Structure
  - Multiple classes/series
- Regulatory Issues
  - Investment adviser – registration type (verify on <http://www.sec.gov/iard>)
  - Other registrations (CFTC/NFA)

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## Aspects of Due Diligence

- Investment Manager
  - Review investment management agreement
  - D&O/E&O/key man life insurance coverage?
  - Key Man Redemption
    - Does the Fund depend on the services of any particular person(s)?
    - If so, in the event of death, departure or incapacity of such persons, are investors provided a right of redemption?
  - Sub-advisers
  - Review biographies for unexplained gaps in time
  - Background checks/research on principals
  - Compliance regime
    - Robust and effective program
    - “Tone at the top”/CCO with authority and substantive experience

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## Aspects of Due Diligence

- Investment Strategy
  - What is strategy?
    - PPM should fully describe strategy in sufficient detail (objective, target returns/benchmarks process, risk management/hedging) and contain appropriate and comprehensive risk disclosures
    - Portfolio limits/guidelines
  - Do the other terms of the fund, such as provisions for designated investments and side pockets, seem appropriate in light of the investment strategy?
  - Leverage/borrowing policy?

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## Aspects of Due Diligence

- Liquidity
  - Voluntary redemptions?
  - Frequency/notice
  - Lock-up (hard or soft)
  - Gates (both fund level and investor level)
    - Redemptions not honored, are they carried over until the next redemption date or cancelled?
  - Payment terms
    - Delay/suspend payment
    - Cash or in-kind
    - Holdback of proceeds until the fund's audit
  - Suspensions
    - Under what circumstances can the fund suspend redemption/calculation of NAV?
  - Designated investments/Side Pockets
    - Limitations on their use?
    - How are designated investments valued?

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## Aspects of Due Diligence

- Fees and Expenses
  - Are the adviser's overhead expenses passed through to the fund?
  - Management fee
  - Performance fee/allocation
    - Undue complexity?
  - Do affiliates of the management company receive fees or commissions from the fund or other service providers (e.g., double-dipping, affiliated broker/dealer)?
  - How are fees calculated on side-pocketed assets?
  - Hidden/insufficiently disclosed fees/expenses?
  - Are service provider fees "market"?
  - Layering of fees and expenses
  - Allocation of shared expenses among related funds

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## Aspects of Due Diligence

- Reports and Valuations
  - Nature and frequency of reports
    - Audited/unaudited
    - Annually/quarterly/monthly
  - Valuation
    - Who values the assets?
    - Third party valuation?
    - Accounting standards? To what extent can valuations deviate from GAAP?
    - Valuation policies and procedures – Valuation Committee?

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## Aspects of Due Diligence

- Potential Conflicts of Interest
  - Trading for other accounts (including personal accounts)
  - Principal transactions
  - Cross trades
  - Other businesses
  - New funds pursuing similar strategy
  - Affiliated transactions/service providers

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### III. Side Letters

- Formal contract
- Typical terms
  - Fees
  - Liquidity
  - Transparency/informational rights
  - Most favored nations status
    - Limited to similarly-situated investors?
    - Cherry-picking?
  - Excluded investments
  - Capacity rights
  - Additional representations and warranties
  - Terms specific to investor due to regulations governing investor

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### Side Letters

- Standardization of terms across your side letters
- Disclosure regarding side letters/confirm appropriate disclosure of discretion and prior side letters
- Transparency/liquidity combo – SEC concerns
- Changes in side letter vs. amendment to existing documents vs. single investor fund/managed account

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**Daren R. Domina**  
Partner

**Haynes and Boone, LLP**  
30 Rockefeller Plaza, 26<sup>th</sup> Floor  
New York, NY 10112  
(212) 659-4963  
[daren.domina@haynesboone.com](mailto:daren.domina@haynesboone.com)

**Heather N. Wyckoff**  
Counsel

**Haynes and Boone, LLP**  
30 Rockefeller Plaza, 26<sup>th</sup> Floor  
New York, NY 10112  
(212) 835-4810  
[heather.wyckoff@haynesboone.com](mailto:heather.wyckoff@haynesboone.com)



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## NATIONAL EXAM PROGRAM

RISK ALERT

By the Office of Compliance Inspections and Examinations<sup>1</sup>

Volume IV, Issue 1 January 28, 2014

### INVESTMENT ADVISER DUE DILIGENCE PROCESSES FOR SELECTING ALTERNATIVE INVESTMENTS AND THEIR RESPECTIVE MANAGERS

For at least the past six years, staff in the Office of Compliance Inspections and Examinations (the “staff” and “OCIE” respectively) have observed and outside studies have indicated that investment advisers, including pension consultants, are increasingly recommending alternative investments to their clients.<sup>2</sup> Investment advisers are fiduciaries and thus must act in their clients’ best interests.<sup>3</sup> An adviser that exercises discretion to purchase alternative investments on behalf of its clients, or that relies on a manager<sup>4</sup> to perform due diligence of alternative investments, must determine whether such investments: (i) meet the clients’ investment objectives; and (ii) are consistent with the investment principles and strategies that were disclosed by the manager to the adviser (as set forth in various documents, such as advisory disclosure documents, private offering memoranda, prospectuses, or other offering materials provided

This Risk Alert summarizes OCIE staff observations on the due diligence practices of certain investment advisers that manage and/or recommend alternative investments to their clients.


Practices employed by some advisers that may provide greater transparency and that independently support the information provided by underlying managers include: (i) the use of separate accounts to gain full transparency and control; (ii) the use of transparency reports issued by independent fund administrators and risk aggregators; (iii) the verification of relationships with critical service providers; (iv) the confirmation of existence of assets; (v) routinely conducting onsite reviews; (vi) the increased emphasis on operational due diligence; and (vii) having independent providers conduct comprehensive background checks.

<sup>1</sup> The views expressed herein are those of the staff of OCIE, in coordination with other Securities and Exchange Commission (“SEC”) staff, including in the Division of Enforcement’s Asset Management Unit and the Division of Investment Management. The Commission has expressed no view on its contents. This document was prepared by the SEC staff and is not legal advice.

<sup>2</sup> Alternative investments include private funds such as hedge funds, private equity, venture capital, real estate, and funds of private funds. According to a June 2012 research report by McKinsey & Company, the Assets Under Management for global alternative investments have grown to a record \$6.5 trillion, having grown at a five-year rate of more than seven times that of traditional asset classes. The study defines alternative investments in a similar way as noted above. McKinsey & Company, *The Mainstreaming of Alternative Investments* (June 2012).

<sup>3</sup> *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), available at <http://www.sec.gov/about/offices/ocie/iainfo/capitalgains1963.pdf>.

<sup>4</sup> As used in this Alert, the term “adviser” refers to registered investment advisers that the staff examined, and “manager” refers to the managers of the alternative investments that the adviser recommends to its clients.



## NATIONAL EXAM PROGRAM

OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

### Examination Priorities for 2014<sup>1</sup>

January 9, 2014

#### I. Introduction

The National Examination Program (“NEP”) is publishing its 2014 examination priorities to communicate with investors and registrants about areas that the staff perceives to have heightened risk and to support the Securities and Exchange Commission (“SEC”) mission to protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation.

These examination priorities areas were selected collaboratively by senior staff from the NEP’s twelve offices, as well as by senior representatives of other SEC divisions and offices, based upon an assessment of a variety of information, including:

- Information reported by registrants in required filings with the SEC,
- Information gathered through examinations conducted by the NEP and other regulators,
- Communications with other U.S. and international regulators and agencies,
- Comments and tips received directly from investors and registrants,
- Data maintained in third party databases,
- Interactions with registrants, industry groups, and service providers outside of examinations, and
- Industry and media publications.

The NEP’s examination priorities address issues that span the entire market, as well as issues that relate specifically to particular business models and organizations. The market-wide priorities are addressed first, followed by the priorities for each of the NEP’s four program areas: (i) investment advisers and investment companies (“IA-IC”), (ii) broker-dealers (“B-D”), (iii) exchanges and self-regulatory organizations (“SROs”, and collectively, “market oversight”), and (iv) clearing and transfer agents (“CA” and “TA”).

This description of NEP priorities is not exhaustive. While the NEP expects to allocate significant resources throughout 2014 to the examination of the issues described below, the NEP will conduct additional examinations in 2014 focused on risks, issues, and policy matters that are not discussed here. These additional examinations may result from market developments, new information learned from

<sup>1</sup> The views expressed herein are those of the staff of the Office of Compliance Inspections and Examinations, in coordination with other SEC staff including the Divisions of Trading and Markets, Enforcement, and Investment Management. The Commission has expressed no view on its contents. This document was prepared by the SEC staff and is not legal advice.

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# AGENDA



8:15	<b>REGISTRATION DESK OPENS</b>
9:00-9:15	<b>Opening Remarks</b> Joseph E. Connarton   Executive Director   PERAC
9:15-12:00	<b>GASB 67 &amp; 68 - Practical Application for Massachusetts Retirement Plans (Part 1)</b> <b>&gt; Panelists:</b> <ul style="list-style-type: none"> <li>• Bill Connolly, Segal</li> <li>• David Driscoll, Buck Consultants</li> <li>• James Lamenzo, PERAC</li> <li>• Larry Stone, Stone Consulting</li> </ul>
	<b>BREAK</b>
	<b>GASB 67 &amp; 68 - Practical Application for Massachusetts Retirement Plans (Part 2)</b> <b>&gt; Panelists:</b> <ul style="list-style-type: none"> <li>• Linda Bournival, KMS Actuaries, LLC</li> <li>• Frank Biron, Melanson Heath</li> <li>• Brock Romano, KPMG LLP</li> </ul> <b>&gt; Questions &amp; Answers</b>
12:00-12:30	<b>Keynote Speaker</b> The <b>Honorable William Galvin</b> , Secretary of State, Commonwealth of MA
12:30-1:30	<b>BUFFET LUNCH</b>
1:30-3:00	<b>Understanding Investment Adviser Registration and Private Fund Due Diligence</b> <b>&gt; Moderator:</b> <ul style="list-style-type: none"> <li>• Derek Moitoso   Compliance Counsel   PERAC</li> </ul> <b>&gt; Panelists:</b> <ul style="list-style-type: none"> <li>• Daren Domina, Haynes &amp; Boone, LLP</li> <li>• Heather Wyckoff, Haynes &amp; Boone, LLP</li> <li>• Michael E. Garrity, U.S. Securities &amp; Exchange Commission (Boston Office)</li> </ul> <b>&gt; Questions &amp; Answers</b>
3:00	<b>FORUM ENDS</b>

